A GROUP INCOME TAX SYSTEM FOR SOUTH AFRICA

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KEAOBAKA PERCIVAL MAHUMA

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ABSTRACT

This thesis establishes a group income tax system for South Africa so that equity may be achieved between the burden of company income tax borne by shareholders who invest in companies that are structured through subsidiaries and shareholders that invest in companies that are structured through divisions. For example, intercompany profits and losses of a revenue nature are subject to income tax whereas interdivisional profits or losses of a revenue nature are not subject to income tax. Also, tax losses incurred by a company are not deductible from taxable income of other companies within the same group whereas in the case of a company that is structured through divisions losses incurred by a division are deductible from income of other divisions of the same company.

The study is classified as 'microcomparison' whereby legal problems that exist in one country are studied on a comparative legal basis. Accordingly, the objective of the thesis is achieved by undertaking a comparative study of group income tax law in the United Kingdom and United States of America for equitable group income tax treatment of problems that exist within the current South African company income tax system.

First, the definition of 'a group' is established, after which a group income tax treatment of group transactions and tax losses is established to eliminate the inequities that are inherent in the South African income tax system. Throughout the study it is demonstrated that these inequities exist in spite of the current income tax avoidance provisions (for example s103 and the connected persons rules).

The conclusions made in the study indicate that the inequity that exists in the South African company income tax system should be eliminated.

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I certify that except as noted above, the report is my own work and all references used are accurately reported.

KEAOBAKA PERCIVAL MAHUMA
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CHAPTER 1

INTRODUCTION

1 Overview

The objective of this thesis is to establish, by examination and analysis of group income tax law in the United Kingdom (UK) and the United States of America (US), a group income tax system for South Africa so that equity is achieved between shareholders of parent companies (holding companies of groups of companies) that carry on business through subsidiary companies and shareholders of companies that carry on similar businesses through divisions.

A group income tax system achieves this equity by treating groups of companies (a group) that are commonly owned by a parent company as a single company that carries on business through divisions.

To achieve this objective the first group income tax issue that is addressed is the definition of 'a group'. This definition is important because a group of companies is not a single legal person. Besides not being a single legal person in its own right, it does not trade as a single legal entity. Each company in the group trades for its own benefit and the income and expenditure of each company in the group is its own, not belonging to the group. Thereafter, the main group income tax issues relating to the recognition of the separate legal identity of each company in the same group are addressed. These are; group transactions and the treatment of tax losses.

2 Background

2.1 Burden of tax

Although a company is liable for income tax as a separate legal entity apart from its shareholders, the burden of company tax is borne by the shareholders and not by the company itself (Chillieah Commission, Zimbabwe, 1986: para 9.54).

In supporting this view the Carter Commission (Canada, 1966: 3) said that

> 'because income tax is collected from corporations *(companies)*... it does not mean that these organizations bear the burden of the tax. Ultimately, the burden of the tax on the organization is the relative reduction in the power of people to consume. This reduction can take form of ... reduced income to those who hold interests in the organization' *(italics in brackets added for clarity).*

Therefore, company income tax is indirectly a tax on the shareholders of that company.

2.2 Equity principle

Equity principle requires that individuals who have the same ability to pay tax should bear the same burden of tax (Margo Commission, South Africa, 1986: para 4.44).

Applied to company income taxation, the equity principle requires that the burden of company income tax borne indirectly by shareholders that have the same ability to pay income tax should always be the same whether those companies carry on business through divisions or through subsidiary companies (Taxation Institute of Australia Research and Education Trust, 1977: 6).

However, if the separate legal identity of each subsidiary company is not disregarded for income tax purposes equity is not always achievable between shareholders who invest in parent companies that carry on business through subsidiaries and those who invest in parent companies that carry on a similar business through divisions. For example:

- intercompany profits or losses of a revenue nature are subject to income tax, whereas interdivisional profits and losses of a revenue nature are not subject to income tax (refer chapter 4); and
- tax losses incurred by a company are not deductible from taxable income of other companies within the same group,

whereas losses incurred by a division of a single company are deductible from income of other divisions of that company (refer chapter 5).

It is for these reasons, mainly, that a group income tax system is necessary so that groups of subsidiary companies that are commonly owned by a parent company should be recognised for income tax purposes as a single legal entity carrying on business through divisions. (US Senate Report, 1918, in: *Gould Coupler Co. (1926) 5 BTA 499 at 515).* As mentioned by the US Senate, the single legal entity treatment of a group is necessary

> '...not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because of the principle of taxing as a business unit what in reality is a business unit is sound and *equitable* ... both to the taxpayer and to the Government' *(emphasis added).*

2.3 Types of group income tax systems

The single legal entity treatment of a group is achieved mainly through two group income tax systems; loss transfer and consolidated returns.

The essence of a loss transfer system, as applied in UK and Australia, is that tax losses incurred by one company in a group are deductible from taxable income of other companies in the same group in the year the tax losses were incurred. The purpose of this system is to achieve results similar to those of a company that carries on trading activities through divisions, whereby losses are deductible from profits in calculating taxable income *(Pilkington Brothers v Commissioner (1982) STC 103 at 107).*

On the contrary, the consolidated tax returns system, as applied in US, requires that in addition to deduction of tax losses incurred by one company from taxable income of other companies within the same group, numerous adjustments should be made in respect of transactions concluded by those companies (for example, adjustments for intercompany transactions) to achieve the effect of a single legal entity on group taxable income.

2.4 Implications of a single legal entity treatment

In order to reflect the effects of a single legal entity in a group income tax system, more than a mere aggregation of the taxable incomes of individual companies in a group is required. As mentioned by the court in *Appeal of Farmers Deposit National Bank and Affiliated Banks (1926) 5 BTA 520 at 526*

> 'the effect of consolidation *(grouping of companies for income tax purposes)* of two or more companies is to weld them together for the purposes of computing the *(income)* tax, as though they existed in effect as a single business enterprise' *(italics in brackets added for clarity).*

As a result of 'welding' together' all companies that are members of the same group for income tax purposes:

(i) the artificial distinction created by separate legal identity is ignored because

> 'the failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of the actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit' *(Zannesville Investment Company v Commissioner (1964) 64-2 USTC para 9 700 at 93 761)*;

(ii) intercompany transactions do not result in any income tax consequences because the parent company is treated as directly owning all assets of its subsidiary companies (Dahlberg, 1987: 547); and

(iii) the group income tax liability in any year only reflects tax consequences of transactions between the group and third parties *(Arizona State Department of Revenue v Transamerica Title Insurance Co et al (1979) 604 P2nd 24 Ariz 417).*

Therefore, it is evident that the single legal entity treatment is intended to treat a group of companies as a single company carrying on business through divisions.

2.5 Advantages and disadvantages

The main advantages and disadvantages of a system of group income taxation are summarised as follows:

2.5.1 Advantages

(i) It avoids business and economic distortions caused by a tax system that ignores that a group of companies constitutes a single economic unit for strategic management and financial planning (Katz Commission, South Africa, 1995: para 10.2 – 10.3);

(ii) it allows the transfer of tax losses amongst companies in the same group (Katz Commission, South Africa, 1995: para 10.2 – 10.3);

(iii) it discourages schemes that avoid income tax by creating capital/revenue mismatches and manipulating cost bases (Katz Commission, South Africa, 1995, para 10.2 –10.3);

(iv) a full group income tax system would provide an audit trail to the fiscal authorities to enable a proper assessment of groups of companies (Katx Commission, South Africa, 1995, 10.2 – 10.3); and

(v) it would encourage groups of companies to undertake new business ventures notwithstanding that they give rise to tax losses in the initial years (Taxation Institute of Australia Research and Education Trust, 1977: 7).

2.5.2 Disadvantages

(i) Group income taxation legislation could in certain instances become complex and would require specialised skills to monitor compliance (Taxation Institute of Australia Research and Eduction Trust, 1977: 7); and

(ii) the cost of administering the system could be high and could put a strain on the existing tax administration system (Budget Review, South Africa, 1996: 2-25).

2.6 Experiences of group income taxation

2.6.1 In other countries

Group income taxation is permitted in most developed countries. In US, for example, group income taxation has been in existence since 1917, and in UK, group income taxation was first introduced in 1953 on a subvention payments system, but was later replaced by the loss transfer system in 1967.

Group income taxation is also permitted in the following countries; Australia, Denmark, France, Luxembourg, Mexico, Netherlands, Germany, New Zealand, Portugal, and Spain.

2.6.2 In South Africa

Except for companies in the shipping industry, group income taxation is not permitted in South Africa in terms of the Income Tax Act no. 58 of 1962, as amended (SA Act).

A holding company and its subsidiary that owns a ship(s) may elect to be treated as a single company if:

(i) the subsidiary (s14(1)(D)):

- does not carry on any other type of business;
- is managed and controlled in South Africa; and

(ii) the holding company is (s14(2)(d)(b)):

- the sole beneficial shareholder of the subsidiary;
- incorporated in terms of the South African law; and
- managed and controlled in the Republic.

2.7 Commissions on group income taxation in South Africa

2.7.1 Margo Commission (1986)

The issue of group income taxation was first considered by the Margo Commission (1986). It recommended by majority that group income taxation should not be introduced. Amongst the reasons cited the following are important:

(i) the State would lose significant revenue if group income taxation is introduced;

(ii) the system could result in abuse of the limited liability by companies;

(iii) tax avoidance using assessed losses would still continue even if group income taxation is implemented; and

(iv) the creditors and minority shareholders could be prejudiced by group income taxation.

2.7.2 Katz Commission (1995)

After reconsidering group income taxation and the arguments presented earlier by the Margo Commission, the Katz Commission (1995) recommended that a simplified form of consolidated returns system should be introduced with a long term view of introducing a full system of group income taxation.

The Commission recommended that such a system should:

(i) be limited to South African companies (as defined);

(ii) initially be extended only to groups with wholly owned subsidiaries; and

(iii) limit pre-acquisition tax losses to the taxable income of the member that incurred those losses.

Although the proposals were accepted in principle for implementation, the decision on the introduction of group income taxation was held 'in abeyance until the new South African Revenue Service is fully operational' (Budget Review, South Africa, 1996: 2-25).

3 Motivation for the study

It may be necessary to carry on a business through a group of companies as opposed to a single company through divisions for various commercial reasons. According to Margo (South Africa, 1986: para 10.98) some of these reasons are to:

(i) comply with the requirements of certain regulated industries;

(ii) comply with the terms of loan covenants and agreements with bankers;

(iii) take advantage of the limited liability protection when undertaking new risk business ventures; and

(iv) raise public finances for each company in the group.

Therefore, the existence of group structures is an unavoidable feature of the commercial world, and it would be unreasonable to expect groups of companies to change structures of their businesses into divisions in order to overcome the inequity of the existing tax system (Taxation Institute of Australia Research and Education Trust, 1977: 7).

This study is undertaken, therefore, to establish a group income tax system for South Africa so that this inequity that is inherent in the South African income tax system may be overcome.

The results of this study are intended to contribute to the knowledge and understanding of group income taxation in South Africa, particularly by the fiscal authorities.

4 Outline of the study

Chapter 1 sets out a background to group income taxation after which the reason for the study is motivated.

In chapter 2, the research problem, research methodology and objectives are described, after which assumptions and limitations underlying the study are stated.

In chapter 3, firstly, the problems associated with identifying a group for group income tax purposes in South Africa are identified. Secondly, definitions of 'a group' in UK and US are examined and analysed to establish a definition of 'a group' for income tax purposes in South Africa.

In chapter 4, main income tax problems relating to the single legal entity treatment of group transactions that exist within the current South African income tax law are identified. Thereafter, an examination and analysis of the income tax treatment of these problems in UK and US is made in order to establish an equitable treatment for group income taxation in South Africa.

Chapter 5 identifies problems relating to the income treatment of tax losses within the existing South African income tax system. Thereafter, an examination and analysis of the UK and US group income tax law is undertaken in order to establish an equitable group income tax treatment for South Africa.

Finally, in chapter 6, the research problem is reconsidered in light of the results of the research, and the research conclusions are summarised. Areas for future research are then identified.

CHAPTER 2

RESEARCH PROBLEM, OBJECTIVES AND METHODOLOGY

1 Introduction

In this chapter, the research problem is identified, the research objectives are stated, after which the research methodology is described. Finally, the assumptions and limitations underlying the study are stated.

2 The research problem

The problem is the inequity that exists in the South African income system regarding the income tax burden borne by shareholders of companies that are structured through divisions and shareholders of parent companies that are structured through subsidiary companies. The impact of this inequity on these shareholders is the relative reduction in the power to consume as measured by dividend income receivable from these companies.

3. The research objectives

3.1 Primary research objective

The primary objective of this study is to establish a group income tax system for South Africa so that equity may be achieved between shareholders who invest in parent companies that carry on business through subsidiary companies and shareholders who invest in parent companies that carry on similar business through divisions, without creating the opportunity for income tax avoidance.

3.2 Secondary research objectives

In order to achieve the primary objective this study is divided into two secondary objectives.

3.2.1 Definition of a group

The first secondary objective is to define groups of companies that qualify for a group income tax system. This problem arises because a group of companies is not a single legal persona *(Milne & Erleigh (7)(1951) 1 SA 791 (AD) at 827 (refer chapter 3, section 2)).*

Besides not being a single legal entity in its own right, a group does not trade as a single legal entity. Each company trades for its own benefit and the income and expenditure of each company is its own, not belonging to the group.

3.2.2 Separate legal identity

The second secondary objective is to establish a system that overcomes the inequity inherent in an income tax system that requires the separate legal identity of each company in the same group to be recognised, but applies income tax principles which are designed for persons acting at arm's length. This inequity arises mainly in the income tax treatment of group transactions and deduction of tax losses.

4 Research methodology

This study is classified as 'microcomparison' whereby legal problems existing in one country are studied on a comparative legal basis (Tumanov, 1985: 69).

It is accepted world-wide that good laws cannot be produced without deriving any assistance from comparative law (Zweigert & Kotz, 1992: 15). Consequently, a comparative study of group income tax law in other countries is fundamental to establishing a good group income tax system for South Africa.

Therefore, the group income tax system for South Africa will be established by:

(i) firstly, identifying problems resulting from the failure of the existing income tax law in South Africa to recognise the group as a single legal entity; thereafter,

(ii) examining and analysing group income tax law in UK and US for treatment of these problems so that an equitable group income tax treatment can be established for South Africa.

The income tax law of UK and US will be examined and analysed only to the extent of identifying main principles that would be relevant to resolve problems identified in South Africa.

4.1 Sample selection

UK and US were selected for this study because group income taxation has long been introduced in these countries (in UK, group income taxation was first introduced in 1953, and in US since 1917), and the choice and development of a group income tax system in South Africa is likely to follow the development of group income taxation in either or both of these countries.

5 Assumptions and limitations

5.1 Assumptions

(i) It is acknowledged that the burden of company tax is not only borne by shareholders of a company. Other persons, for example, customers also bear the burden of the company tax for examples value added tax (VAT) (Asprey Commission, Australia, 1975: para 16.00). However, for the purposes of this study it is assumed that shareholders bear the total burden of the income tax on companies.

(ii) In both UK and US, companies are taxed on a residence basis on their world-wide income and not on the source basis, as is the case in South Africa. The only exception in South Africa is in respect of the income taxation of investment income, which is taxed on a residence basis of taxation. It is therefore assumed that the principles of group income taxation in these countries would still be applicable and appropriate for the development of a group income tax system in South Africa.

(iii) The existing anti-tax avoidance legislation in South Africa, will supplement the group income tax legislation when introduced so that grouping of companies purely for tax avoidance reasons could be prevented.

(iv) In a group income tax system, groups of companies may be assessed on a single tax return or multiple tax return basis. The merits and demerits of these bases are not considered in this thesis because they are of an administrative nature. For the purposes of this study, it is assumed that a group of companies will be assessed on a single tax return basis.

5.2 Limitations

(i) In designing a tax system, all characteristics of a good tax system; equity, efficiency, neutrality, and simplicity should be considered. However, this study focuses only on the equity principle because it is the prime characteristic (Smith Committee, Canada, 1967a: 16).

(ii) Equity principle applies only to real persons (Smith Committee, Canada, 1967b: 92), therefore this study is limited to groups of companies whose shareholders of the parent company are natural persons.

(iii) As the UK group income tax system, unlike the US system, applies only to tax losses incurred in the current tax year (refer section 2.3 (chapter 1)), this research is biased towards the US group income tax system.

(iv) Where there are differences in the basis of taxation or absence of relevant income tax law in UK and US, propositions are based on SA case law.

(v) The research is based on UK and US income tax legislation that was in effect for tax years ending as at 31 December 1996. In US, in particular, proposed income tax regulations existed as at that date that require the extension of single legal entity treatment to acquiring or selling groups of companies. These regulations were excluded from the research for the reason that they were not part of the income tax legislation that was in effect as at that date.

(vi) In UK, group income taxation is also available to consortiums of companies. This group income tax system was excluded from this study because there is no comparable system in US.

(vii) This study does not consider group income taxation of companies in specialised industries, for example; insurance and mining companies.

(viii) For purposes of simplicity, this study does not deal with the income tax implications of mergers, restructuring of groups of companies, and Double Tax Agreements (DTA's).

CHAPTER 3

DEFINITION OF A GROUP

1 Introduction

In this chapter, the aspects relating to identification of a group of companies as a single legal entity for income tax purposes are first discussed, after which an examination and analysis of the definition of 'a group' in UK and US is made in order to establish an appropriate definition of 'a group' for group income taxation in South Africa.

2 Definition of a group in South Africa

In terms of the SA Act, a liability for income tax purposes arises in respect of taxable income received or accrued to or in favour of ***any person*** (s5(1)(c)).

According to common law, a group of companies (a group) cannot be recognised as a separate legal *person (Milne & Erleigh (7) 1951 1 SA 791 (AD) at 827)*. In this case, in rejecting that a group is a legal entity the court said that a group is

> 'an association of companies, created... by the acts of individuals... and are controlled as to the appointment of their directors, and therefore as to the administration of their affairs by one or a few people. The persons who wield the controlling power are the only legal personae apart from the companies themselves. There is no persona which is the group'.

For income tax purposes, whether or not a group of companies is a person has not been an issue because all companies are taxed on a separate legal entity basis (except companies in shipping industry refer section 2.6.2, chapter 1).

The only other way that a group can become a person for income tax purposes is if it is a person as defined in the Interpretation Act no. 33 of 1957, as amended. According to this Act, a person includes 'a body of persons unincorporate' (s2).

It is established law that a body of persons unincorporate means a body of persons which does not have a legal persona separate from its constituent members *(Witwatersrand Association of Racing Clubs (1960) 23 SATC 380 at 394)*. In this case a certain association, which consisted of representatives from other race courses, organised a race meeting from which it received income. The court held that the association was a person for income tax purposes even though it had no legal persona separate from its constituent members.

It could be argued that a group of companies is in a similar position as the association in Witwatersrand's case (supra), because, it consists of legal persona separate from its members (companies). Furthermore, similar to the association in Witwatersrand's case (supra), a group of companies has as a common purpose, to maximise profits for the shareholders of the parent company.

However, in terms of South African tax law, a group of companies does not receive income as a single legal entity. Furthermore, there is no specific legislation (other than for the purposes of secondary tax on companies (STC)) that requires that a group of companies should be treated as a single legal entity for income tax purposes. However, the STC legislation applies to the taxation of dividends and not the income taxation of groups of companies. Accordingly, this legislation is considered to be inadequate for a group income tax system.

The problem is, therefore, that the South African income tax legislation does not define:

(i) which companies (domestic and foreign) qualify for inclusion in the same group and which do not (qualifying companies);

(ii) the nature and extent of ownership, that should exist before companies are included in the same group for income tax purposes(ownership);

(iii) nature of control that should exist before companies are included in the same group (control); and

(iv) the value of equity of any company that should be owned by the group before the company is included in a group (value).

Hereafter, the treatment of these problems in UK and US is examined and analysed so that the definition of 'a group' for group income tax purposes in South Africa can be established.

3 Qualifying companies

In terms of SA Act, a company includes (s1):

(i) companies incorporated by laws of the Republic of South Africa (hereafter domestic companies); and

(ii) any other company incorporated under laws of any other country if it carries on business or derives income from a source or deemed source in South Africa (foreign companies).

The problem is whether or not all companies as defined in the SA Act should be included in a group income tax system.

In UK, group income taxation is only available to companies that have been incorporated in the UK (hereafter domestic companies) and companies that have been incorporated in other countries (hereafter foreign companies) if they are controlled and managed in the UK (both types of companies referred to as UK resident companies), if shares of such companies are held through UK resident companies (Income and Corporations Act of 1988, as amended (UK Act), s413(5)).

However, in US, group income taxation is only available to companies that have been incorporated under the US law (hereafter referred to as domestic companies) and not to any foreign companies (Inland Revenue Code of 1986, as amended (US Act), s7701(a)(3&4); s1504(b)(3)).

It should be noted that as a result of the differences in the basis of company taxation between South Africa, and these countries, the guidance derived from these income tax systems is of limited assistance to South Africa. In South Africa companies are taxed on a source basis, whereas in UK and US companies are taxed on a residence system based on their worldwide income.

A useful guidance in deciding whether or not any company should be included is that a system of group income taxation should be limited to companies that are not subject to foreign tax laws *(Imperial Chemical Industries v Colmer (1993) 4 All ER 705 at 711)*. According to this case, domestic companies (as defined above) that are subject to only South African tax qualify to be included in a group income tax system. Although the principle from this case may be correct, it may create problems with Double Tax Agreements (DTA's), which require non-discrimination between domestic and foreign companies. The issue of DTA's is, however, outside the scope of this thesis.

However, the inclusion or exclusion of domestic subsidiaries of a foreign parent company, that is not subject to income in South Africa, remains to be resolved. In similar circumstances, where the UK court had to determine whether or not group income taxation was permissible between two resident companies (as defined above) whose shares were held by a non-resident parent company (not subject to income tax in UK), the court held that it was not necessary for the parent company to be a resident in UK because it was not involved in the surrendering of the tax losses that were in issue *(Imperial Chemical Industries's case (supra)).* However, the correctness of this case is doubted because it is still on appeal *(Imperial Chemical Industries v Colmer (1996) STC 352).*

It is considered that, to allow group income tax in such circumstances would be inconsistent with treating a group as a single legal entity, which requires that the parent company and its subsidiaries of a parent company are treated as a single company operating through divisions (Collins & Schneider, 1996: 5; also refer section 2.3, chapter 1). Therefore, if the parent company is not subject to income taxation in South Africa, it is considered inappropriate to include its subsidiaries ('the branches or divisions of the taxpayer') in a group income tax system.

This situation should be distinguished from a situation where the taxpayer (the parent company) is subject to income tax in South Africa, but some or all of its divisions or branches (the subsidiaries) are not subject to income tax in South Africa, in which case group income tax would still be appropriate.

> Similarly, domestic branches of foreign companies should not be included in a group income tax system for the reason that the parent company is not subject to income taxation in South Africa.

For the reason that inclusion of domestic companies (as defined in this subsection) that are held through a foreign holding company and branches of foreign companies would be inconsistent with the treatment of a group of companies as a single legal entity, the group income tax system should be restricted to domestic companies that are held by a domestic parent company.

However, to the extent domestic companies derive income wholly from a source outside South Africa, inclusion of such companies in a group income tax system would serve no purpose because income derived by such companies would in any event not be, except for transfer pricing adjustments that may be required, subject to income tax in South Africa.

Furthermore, it is submitted that there is no justification to exclude domestic companies that derive income partially from a source or deemed source outside South Africa on the basis that their inclusion would raise a problem of source or deemed source of income. The problem of source, however, is outside the scope of this research because it is not only a group income tax problem.

4 Ownership

The purpose of grouping of companies for taxation purposes is that companies that are in effect one business unit, because of their actual ownership, should be taxed as such *(Miami National Bank v Commissioner (1977) 67 TC 793 at 798).*

4.1 Legal and beneficial ownership

Where registered (or legal) and beneficial ownership are held by different legal personae, the problem is to identify a type of ownership that is appropriate for a group income tax system.

In UK, it is settled law that the beneficial ownership is appropriate for a group income tax system (s838(3) UK Act). Similarly, in US, court decisions have established that beneficial ownership, and not legal ownership, is required for group income tax purposes *(Miami National Bank (supra) at 799; also INI Inc. v Commissioner (1995) TCM para 95 112 at 95-689).*

If legal ownership was accepted as the appropriate ownership for group income taxation purposes, it would lead to absurd practices because companies holding shares in their capacity as trustees (trust companies) would be required to file group income tax returns in respect of those shares *(Macon, Dublin and Savannah Railroad Company v Commissioner (1939) 40 BTA 1 266 at 1 273).*

On the contrary, as dominium on the shares is held by a beneficial owner *(Macon's case (supra)),* this type of ownership is considered appropriate because it would allow companies with real economic interest or real common ownership to consolidate the income and deductions for income tax purposes *(George Georgiou et al v Commissioner (1995) TCM para 95 546 at 3 520-95).*

Furthermore, beneficial ownership places a parent company in a similar economic position as a single company that carries on business through divisions because divisions are beneficially owned by that company.

For these reasons, beneficial ownership, and not legal ownership, is appropriate for a group income tax system in South Africa.

4.2 Classes of shares

The capital structure of a company permitted in terms of South African company law could consist of ordinary shares and preference shares. The distinction between these classes of shares lies mainly in the rights attaching to them. Firstly, the preference shares have a preferred right to dividends when declared. Secondly, voting rights relating to preference shares may be altered in terms of Articles of Association (s194 Companies Act no. 61 of 1973, as amended).

For the reason that classes of shares have different rights attaching to them the problem is whether or not all classes of shares should be taken into account in determining ownership for group income taxation purposes.

In the UK, all types of shares are included except those that have a right to a dividend at a fixed rate, and have no other right to share in the profits of the company (s832(1); s838(1)(b) UK Act).

In the US, all classes of shares are taken into account except if any class of shares (s1504(a)(4) US Act):

(i) is limited and preferred and does not participate in corporate growth to any significant extent;

(ii) has redemption and liquidation rights not exceeding the issue price of such shares (except for a reasonable redemption premium);

(iii) is not entitled to vote for directors who control the management of the company *(Erie Lighting Company Commissioner (1938) 38-1 USTC para 9 030);* and

(iv) is not convertible into any other class of shares.

Although the limitation of rights to participate in profits (either by fixing a rate of dividends, or fixing the redemption and liquidation rights) of a company under both systems amounts to 'stripping off' the equity characteristics of any class of shares to make it 'debt' (Miller, 1991: 224), the additional requirements in US system are, it is submitted, equally important to be taken into account in determining whether or not a class of shares should not be taken into account indetermining ownership for group income tax purposes.

4.2.1 Right to vote

It is submitted that the absence of this requirement in the UK system could result in exclusion of shares that have controlling power of the subsidiary company in cases where controlling power between classes of shares can be varied (control is discussed in detail in section 5).

4.2.2 Convertibility of the shares

As convertibility is not a requirement in UK, it would be possible for parent companies to sell a loss-making subsidiary to a profitable group by selling ordinary shares, whilst retaining ownership of non-voting and convertible preference shares. These schemes (as previously common in US) would give the parent company the option of acquiring the subsidiary at a later stage by converting such shares into ordinary shares (Miller, 1991: 222).

For the reason that:

- the right to vote for directors would ensure that control remains in the group (and not held by outsiders); and
- that restriction on convertibility to other classes of shares would prevent income tax avoidance,

in addition to the limitation on rights to participate in profits, a class of shares should not be taken into account in determining ownership for group income taxation purposes if it does not possess voting rights to elect directors who control the affairs of the company and is not convertible into any other classes of shares.

4.3 Extent of ownership

Although 75% ownership is required in UK (s413(7) UK Act) and 80% in US (s1504(a)(2) US Act) is required before grouping of companies is allowed, there is an accepted view that any percentage between 51% and 100% is acceptable because there is no objective benchmark at which grouping of companies for income taxation purposes should commence, and to limit grouping to companies that are wholly owned by the group would be unnecessarily restrictive (Taxation Institute of Australia Education and Research Trust, 1977: 19). This view is supported by differences in the extent of required ownership, for group income taxation purposes in other countries. For example,

> 'common ownership of 100 percent is required in order to file consolidated returns in ... Denmark, 99 percent in the Netherlands, 95 percent in France, 90 percent in Portugal and Spain... in Australia the requirement is 100 percent... and in New Zealand 66 percent' (Katz Commission, South Africa, 1995: 102).

However, it is considered that to permit grouping of companies for income tax purposes where the group owns less than 100% of the shares of the subsidiary (refer section 4.2(above) for exceptions) would be inconsistent with the single legal entity treatment which considers the existence of minority shareholders as a distortion to the interest of the group in the subsidiary companies (Duboff & Broadbent, 1994: 746).

Furthermore, the existence of minority shareholders increases the risk of carrying on the business of a group in the interest of the group and of minority shareholders (*Pioneer Parachute Company Inc. v Commissioner (1947) 47-2 USTC para 5 911 at 12 642)*, which it is considered, would be inconsistent with the economic unity that the single legal entity treatment is intended to achieve.

For the reason that inclusion of companies with minority shareholders in a group for income tax purposes would be inconsistent with the single legal entity treatment of a group of companies, grouping of companies should be restricted to companies whose shares are not owned by minority shareholders.

4.4 Direct or indirect shareholding

As it has already been established that group income tax system should be limited to companies in which there are no minority shareholders, the question of direct and indirect shareholding of the parent company in the subsidiary companies is not an issue because all subsidiary companies are ultimately owned by the shareholders of the parent companies.

4.5 Specific inclusion

Under normal principles of ownership (as discussed above), options to acquire shares would generally not qualify to be taken into account to determine ownership for grouping purposes, because options do not represent a right of ownership, but only continuing offers and potential sources of income to the shareholders *(Palmer v Commissioner (1937) 37-2 USTC para 9 532 at 10 512).*

Previously, through arrangements between groups of companies, a loss-making subsidiary could be moved out of a group that had insufficient profits to utilise the tax losses in a profitable group, and the first group would, by means of options, buy back the subsidiary after the tax losses had been utilised by the profitable group *(Sheperd v Law Land (1990) STC 795 at 801- 802).*

The problem, therefore, is to identify circumstances under which options should be taken into account in determining ownership for a group income tax system.

In UK, in general, all options are deemed to be exercised in determining ownership (Schedule 18 para (5B(1)-(3)) UK Act). The only exception relates to options that relate to fixed rate preference shares, normal commercial loans and certain employee ownership options (Schedule 18 para 5B(4)(d) UK Act).

However, in US, options are only taken into account in determining ownership if, on date of issue or transfer or date on which the terms of existing options or underlying shares are adjusted (the measurement date) (Final and Temporary Regulations under Inland Revenue Code of 1986, as amended, (Reg) 1.1504-4(b)(2)):

- it could reasonably be anticipated that the issue or transfer of such option or transfer of underlying shares will result in avoidance of substantial amount of income tax; and
- it is certain that the options will be exercised.

It is submitted that the UK system leads to fewer uncertainties because it takes into account all options. However, the only limitation with such a system is that in some instances it could interfere with legitimate commercial transactions that are not driven by income tax avoidance motives (New York State Bar Association, 1985: 904).

This problem is less likely to occur under the US system because, its purpose is to take into account options only in circumstances that indicate tax avoidance (New York State Bar Association, 1985: 904).

For the reason that the US system is less likely to interfere with commercial transactions that are not intended for income tax avoidance, options should be deemed to be exercised for group income tax purposes, only to the extent that these options are indicative of income tax avoidance motives.

The only problem would be, like in US, to identify circumstances that constitute income tax avoidance. A simple solution to this problem would be to identify circumstances that do not constitute income tax avoidance. In US, options to acquire (or sell) shares are not considered part of income tax avoidance for group income tax purposes if (Reg 1.1504-4(g)(3)):

(i) the terms of the contract provide that the exercise price of an option is equal to or greater than (less than, in the case of an option to sell) the fair market value of the underlying exercise date; or

(ii) the option may be exercised within 2 years after the measurement date and the exercise price is equal to or greater than 90% (or less than 110% in the case of an option to sell) of the market value of the underlying shares on the measurement date.

5 Control

Directors of a company are generally responsible for managing and controlling the business of the company (Table A - article 59; Table B - article 60, Companies Act no. 61 of 1973, as amended), and where powers of management are vested in them they alone can exercise those powers *(Shaw & Sons (Salford) Ltd v Shaw (1935) 2 KB 113 (CA)* in: Van Dorsten, 1993: 228).

However, the issue with groups of companies is that, unlike divisionalised companies, although a group may beneficially own all the qualifying classes of shares of a subsidiary company (as discussed in section 4.2 above) it may not be able to control that subsidiary company. For example, this would be the case where the controlling power of a subsidiary company is held by a shareholder who owns non-qualifying classes of shares (as discussed in section 4.2 above).

Therefore, the problem is to identify circumstances that constitute control so that only subsidiary companies that are beneficially owned and controlled by the same group should be included in a group income tax system.

In UK, control for group income taxation purposes exists if either of the following conditions apply (s410(1)(b)(ii); s840 UK Act):

(i) any person through possession of voting power or ownership of shares, such person has power to control the affairs of the company according to the wishes of that person; or

(ii) if by virtue of any powers conferred in the Articles of Association or any other document, the affairs of the company are conducted according to the wishes of that person. This type of control is of an impermanent and transient nature to take into account that powers conferred by articles may be varied or altered *(Irving v Tesco Stores Holdings Ltd (1982) 58 TC 1 at 36).* The court in this case had to decide whether or not control existed where there are arrangements in respect of which some of the directors were not subject to control of the majority shareholders.

In US, where there are no restrictions on the powers of directors, any person is deemed to have control for group income tax purposes, if that person holds shares that possess voting power to elect 80% of the total number of directors *(Erie Lighting (supra); also Hermes Consolidated Inc. and*

Consolidated Subsidiaries v US (1988) 88-1 USTC para 9 220 at 83 428).

Although in simple cases, voting power at shareholder level (refer (a) above) could be indicative of control of the affairs of the company, in cases where voting powers of shareholders are altered in such a way that some or all directors are not subject to voting power exercised by some shareholders, this type of control would not be an appropriate measure of control of the affairs of the company. This view has support in both UK and US.

In UK, where a parent company held majority shares in the subsidiary in terms of an arrangement whereby control of the board of directors was not exercised by the holding company, the court refused to accept that voting power at shareholder level would constitute control *(Tesco Stores (supra) at 36).*

Similarly, in US, where a certain class of shares possessed voting rights in respect of certain shareholder issues, but not voting rights in respect of voting for directors, the court refused to accept that those shareholders held shares that control the company *(Erie Lighting (supra)).*

As an alternative to voting power exercised at shareholder level, control at the board of directors level (US system) has also been supported as an appropriate measure of control of the affairs of a company for group income taxation purposes in UK (refer (b) above). In both countries, election of majority directors is considered an appropriate measure of control if there are no restrictions on the powers of directors to manage the affairs of the company.

In *Tesco's case (supra*) at 38, the court said that

> '...control at board level is sufficient where the Articles contained provisions equivalent to those in Article 80'.

The provisions of article 80 read as follows (at 36):

> 'the business of the company shall be managed by the directors, who may ... exercise all such powers of the company as are not by the Companies Act ... required to be exercised ...in general meeting'.

It is submitted that for control to exist, it is not necessary to require a parent company to hold shares that elect 80% of the directors (US system). It is considered sufficient to show that the parent company holds shares that can elect majority of the directors (UK system), because, in any event, according to South African company law, resolutions taken at directors meetings by majority are binding on the minority directors *(Robinson v Imroth and Others (1917) WLD 159*, in: Van

> Dorsten, 1993: 242*)*. Therefore, if it could be shown that a shareholder can elect majority directors, it is considered that control would be established for group income tax purposes. However, where there are arrangements in terms of which powers of directors to manage the business are restricted, election of majority directors would not on its own be an appropriate measure of control of the affairs of the company *(Tesco's case(supra))*. This problem has also been identified in US, although there is no direct authority on this issue as yet (US letter ruling 9452002; Huber et al, 1995: 17).
>
> In US letter ruling 9452002, Inland Revenue (US) gave a ruling similar to the decision of Tesco's decision (supra)), to the effect that where there are restrictions on the rights of directors, the election of majority of directors is not the sole test. It was ruled that all circumstances of each case should be taken into account.

As control at the board of directors' level (as defined by election of majority of directors' to the board) is generally more appropriate as a measure of control over the affairs of a company than control at shareholders' level, control for group income tax purposes should be defined as control at board of directors. However, where there are limitations on the powers of directors, other relevant circumstances should be taken into account.

6 Value of equity

Prior to the introduction of the requirements of holding value of the equity of the subsidiary, it was possible for a parent company to consolidate and derive tax benefits from a loss making subsidiary in which it only had a minimum capital risk (New York State Bar Association,1985: 896; Deficit Reduction Act of 1984: 834).

It was also possible to create a structure under which a loss making company could become a subsidiary of one company which desired to use its tax losses for group income taxation purposes, when in reality this loss making company was a subsidiary of another company which had no taxable income from which the tax losses would be deducted *(Sheperd v Law Land (1990) STC 795 at 801).*

Thus, the value test was introduced to ensure that a parent company that derives tax benefits for using tax losses of a subsidiary owns a substantial value of the equity of the subsidiary (New York State Bar Association, 1985: 897).

The problem is therefore to identify an appropriate method of valuing equity for group income tax purposes.

However, these problems exist in these systems because grouping of companies is permitted where minority shareholders exist in a group. As it has already been established that grouping of companies should only be restricted to companies that are wholly owned by the parent company (section 4.3, above), this problem would not be relevant for this study. Therefore, no further study of the valuation method is undertaken.

7 Chapter summary

In this chapter, firstly, problems relating to the identification of a group for income tax purposes were discussed. These problems relate to identifying companies that qualify for group income taxation, defining the nature and extent of ownership and nature of control. The value of equity that should be held by the group is not a relevant issue because the definition of a group is limited to companies that are wholly owned by the group. Based on the definition of a group in UK and US, a definition of a group that is consistent with the single legaltity treatment of a group has been established.

CHAPTER 4

GROUP TRANSACTIONS

1 Introduction

In this chapter, the income tax problems relating to group transactions are first identified after which the UK and US group income tax law is analysed so that an equitable group income tax treatment for South Africa can be established.

First, intercompany transactions are studied after which income tax implications of disposal and acquisition of subsidiary companies are dealt with. Finally, expenditure incurred on behalf of, or for the purposes of trade carried on by other companies within the same group is considered.

2 Intercompany transactions

In general, where an intercompany transaction results in revenue income for one company and revenue expenditure for another company within the same group, (for example, rental income and rental expenditure) these amounts will offset each other for income tax purposes and there would not be any income tax effect to the group.

However, where intercompany transactions relate to transfers of assets between companies within the same group, the resultant intercompany profits or losses may have an income tax effect on group taxable income which would not have otherwise occurred if those companies were divisions of a single company.

The US group income tax law relating to intercompany transactions on which the examination and analysis is made was published only in July 1995, and consequently there is no US case law on this legislation as yet.

The UK group income tax system is not considered in this subsection because group income tax system in that country applies only to the transfer of tax losses, and like in South Africa, the income tax law does not deal with the single legal entity income tax treatment of intercompany transactions (Katz Commission, South Africa, 1995: para 10.3.1).

2.1 Trading stock

Where a company that carries on business through divisions transfers trading stock held and not disposed of at the beginning of the tax year to another division no profit or losses would be recognised on such a transfer (s22(8)(B)(a); s22(2) SA Act).

However, in a case of group of companies a transfer of trading stock from one company (first company) to another (acquiring company) would result in intercompany profit or loss being recognised in the taxable income of the first company (s22(2); s1 SA Act).

Therefore the problem is to identify an equitable treatment of intercompany profits or losses on the transfer of trading stock to achieve the income tax effect of a single legal entity on group taxable income.

In US, the income tax consequences of any intercompany profit or loss arising from the transfer of an asset within the group is initially determined by recognising the separate legal identity of each company in the group, subject to the adjustment discussed below (Reg 1.1502-13(a)(2)).

Accordingly, the intercompany profit or loss on the transfer of trading stock will be initially determined as the difference between cost and proceeds received by or accrued to the first company.

Thereafter, any adjustments that may be required to the intercompany profit or losses so determined depend on whether the acquiring company holds that asset as:

- trading stock or capital asset; and
- whether or not that asset is sold by the acquiring company outside the group.

2.1.1 Trading stock

The intercompany profit or loss is adjusted to only recognise in group taxable income for each tax year the difference between (Reg 1.1502-13(c)(2)(ii)):

- any profit or loss on the asset actually recognised in group taxable income by the acquiring company; and
- any profit or loss on the asset that would be recognised in group taxable income if the first and acquiring companies were divisions of a single taxpayer.

As discussed above, a transfer of trading stock between divisions of the same company does not result in an intercompany profit or loss in terms of the existing income tax law in South Africa.

Similarly, the acquiring company will not recognise any profit or loss on the asset that has been sold outside the group (refer section 2.1.3).

Accordingly, the US treatment would require that intercompany profits or losses should be deferred entirely and not recognised in group taxable income.

Clearly, as long as the acquiring company still holds that trading stock the intercompany profit or loss on that asset would be deferred.

Furthermore, the deferral of intercompany profits or losses eliminates transfer pricing issues, because whether or not the assets are transferred at market value, the resultant intercompany profit or loss is deferred.

Therefore, by deferring intercompany profit or loss on the transfer of trading stock, a group of companies is placed in a similar position to a single company that carries on trade through divisions.

Thus, an equitable income tax treatment of intercompany profit or loss arising from a transfer of trading stock within the group is to defer such profit or loss (refer section 2.1.3 for treatment upon disposal outside the group).

2.1.2. Capital asset

The intercompany profit or loss on transfer of trading stock to a company within the same group, which holds the asset as a capital asset, is adjusted to recognise in group taxable income for each year only the difference between (Reg 1.1502-13(c)(2)(ii)):

- the actual capital allowance claimed for income tax purposes on that asset based on the cost of the asset to the acquiring company (Reg 1.1502-13(c)(7)(e.g.4)); and
- any capital allowance on that asset that would be recognised in group taxable income if the first and acquiring companies were divisions of a single taxpayer (Reg 1.1502-13(c)(7)(e.g.4)).

> Accordingly, if the acquiring company does not qualify for capital allowances on the transferred asset there will not be any difference, and the entire intercompany profit or loss would be deferred and not taken into account in determining group taxable income for any year.
>
> However, where the acquiring company can claim allowances on the transferred asset, the effect of the US treatment is that intercompany profit or loss would be recognised in group taxable income over the period during which that asset is written off for income tax purposes.
>
> This treatment eliminates the transfer pricing issue because the net of capital allowances claimed on the asset and the intercompany profits or losses recognised each year in group taxable income equals the capital allowance that would be claimed by a single parent company that is structured divisionally (refer example 1, appendix).

Therefore, an equitable income tax treatment of intercompany profits or losses, is to recognise such amounts in group taxable income to the extent there is a difference in amount between capital allowances that are actually claimed by the acquiring company and capital allowances that would have been claimed if the group was a single company that is structured divisionally (disposal of assets outside the group is dealt with in section 2.1.3 below).

2.1.3 Subsequent disposal outside the group

In US, if the acquiring company sells outside the group an asset that was acquired in an intercompany transaction, whether that asset is held as trading stock or as a capital asset, the profit or loss on disposal is ***initially*** determined on a basis that recognises the separate legal identity of each company (Reg 1.1502-13(a)(2)). Therefore, the profit or loss on disposal of the asset that would initially be recognised in group taxable income would be the difference between cost and proceeds received by or accrued to the acquiring company.

Thereafter, any deferred intercompany profit or loss balance that was not recognised in group taxable income in previous tax years would be recognised in group taxable income in the year of disposal to the extent there is a difference between (Reg 1.1502-13(c)(2)(ii)):

- actual profit or loss recognised by the acquiring company from such disposal; and

- any profit or loss that would be recognised if the first and the acquiring companies were divisions of a single parent company.

Applied to South Africa, these adjustments would only be applicable if the acquiring company was entitled to claim capital allowances on the transferred asset.

If the acquiring company was not entitled to claim capital allowances on the transferred asset, the difference between profit or loss recognised by the acquiring company (being profit or loss of a capital nature) and any profit or loss that would have been recognised by a single company that carries on business through divisions (also being profit or loss of a capital nature) would be nil. Therefore, any intercompany profit or loss that was previously deferred, would not be recognised in group taxable income in the year of disposal.

However, if the deferred intercompany profit or loss (whether of a capital or revenue nature) is recognised in group taxable income in the year of disposal of the asset, a group of companies is placed in a similar income tax position as a single company that is structured divisionally because the total profit or loss is equivalent to the sum of the profit or loss to the acquiring company in the year of disposal and any deferred intercompany profit or loss balance that was previously not recognised in group taxable income (as determined above).

Therefore, an equitable income tax treatment of any deferred intercompany profit or loss on group taxable income is to recognise such profit or loss in group taxable income in the tax year the assets are sold outside the group (refer example 2, appendix).

However, that profit or loss should be recognised only to the extent there is a difference between profit or loss determined by the acquiring company and profit or loss that would have been recognised if the acquiring and first companies were divisions of a single company.

2.2 Capital asset

Where a company that carries a business through divisions transfers a capital asset to another division, no profit or loss would be recognised on that transfer because there is no receipt or accrual to that company (s8(4)(a); s11(o) SA Act).

However, in a case of a group of companies, where a capital asset is transferred from one company (first company) to another (acquiring company), an intercompany profit or loss would arise. To the extent such intercompany profit represents a recovery of capital allowances previously granted, then such profit is classified as a recoupment and it would be included in taxable income of the first company in the year of transfer (s8(4)(a) SA Act). Similarly, if the transfer of the asset constituted cessation of use of that asset in the ordinary course of trade (ITC 1 487), the intercompany loss (scrapping allowance) would be deducted from taxable income of the first company in the year of transfer (s11(o) SA Act).

Therefore, the problem is to identify an equitable income tax treatment of any intercompany profits (including recoupment) and losses (including scrapping allowances) to achieve the effect of a single legal entity on group taxable income.

In US, intercompany profit or loss on disposal of the capital asset is ***initially*** computed on a separate legal entity basis by recognising the separate legal distinction of each company, subject to adjustments discussed below (Reg 1.1.502-13(a)(2)).

The nature and the extent of the required adjustments depends on whether that capital asset is held by the acquiring company as trading stock or as a capital asset, and whether or not the acquiring company sells the asset outside the group.

2.2.1 Trading stock

The intercompany recoupment and scrapping allowance, as determined above, would only be adjusted to take into account in group taxable income the difference between (Reg 1.1502-13(c)(2)(ii)):

- any profit or loss actually recognised by the acquiring company on that asset; and
- any profit or losses that would have been recognised on that asset by a single company if both acquiring company and first company were divisions of that company.

As the asset would still be held and not disposed of by the acquiring company, no profit or loss would be recognised on that asset.

Furthermore, as discussed above, a single company carrying on business through divisions would also not have recognised any profit or loss as upon transfer of that asset from one division to another.

Accordingly, the intercompany recoupment or scrapping allowances would not be recognised in group taxable income as long as the asset is held and not disposed of by the acquiring company.

This treatment is consistent with the treatment of a group as a single company that carries on business through divisions.

Therefore it is equitable to defer intercompany recoupment or scrapping allowances arising from a transfer of capital asset between companies within the same group, as long as that asset, if held as trading stock, is still held within the group (refer example 3, appendix).

2.2.2 Capital asset

In US, the intercompany recoupment or scrapping allowance on the transfer of the asset is adjusted to recognise in group taxable income the difference between (Reg 1.1502-13(c)(2)(ii); Reg 1.1502-13(c)(7)(e.g.4)):

- any capital allowance on the asset actually recognised in group taxable income (above); and
- any capital allowance on the asset that would be recognised in taxable income of a single company if the first and acquiring companies were divisions of that company.

Accordingly, the intercompany recoupment or scrapping allowance would only be recognised in group taxable income for each year to the extent that the actual capital allowance claimed by the acquiring company for income tax purposes differs from the capital allowance that would have been claimed if the acquiring company and the first company were divisions of a single company.

Clearly, if there is no difference between capital allowances actually claimed and capital allowances that would be claimed if the acquiring company and the first companies were divisions of the same company, the intercompany recoupment or scrapping allowance balances would not be recognised in group taxable income.

However where there is a difference, as determined above, then each year the intercompany recoupment and scrapping allowances would be recognised in group taxable income over the income tax write off period of that capital asset.

This treatment eliminates the transfer pricing issue because the net of capital allowances claimed on the asset and intercompany recoupments or scrapping allowances recognised each year in group taxable income equals the capital allowance that would be claimed by a single parent company that is structured divisionally.

Therefore, an equitable income tax treatment of intercompany profits or losses, including recoupments or scrapping allowances, is to recognise in group taxable income such amounts to the extent there is a difference between any capital allowance that is claimed by the acquiring company and the capital allowance that would be claimed if the acquiring company and the first company were divisions of the same company (disposals are discussed in section 2.2.3).

2.2.3 Subsequent disposal outside the group

In US if the acquiring company sells outside the group an asset, whether that asset is held as trading stock or as a capital asset, that was acquired in an intercompany transaction, the profit or loss on disposal is ***initially*** determined on a basis that recognises the separate legal identity of that company (Reg 1.1502-13(a)(2)).

Consequently, the profit or loss on that asset is initially determined based on the tax value and the proceeds to the acquiring company.

Thereafter, any deferred intercompany profit (including recoupment) or loss (including scrapping allowance) balances that were not recognised in group taxable income in previous tax years is recognised by taking into group taxable income the difference between (Reg 1.1502-13(c)(2)(ii)):

- actual profit or loss recognised by the acquiring company from such disposal; and
- any profit or loss that would be recognised had the first and the acquiring companies been divisions of a single parent company.

Clearly, according to this treatment intercompany profits or losses that were previously of a capital nature, as determined at the time the asset was transferred, may be reclassified as profits or losses of a revenue nature and included in group taxable income. This would be the case where the acquiring company held the asset acquired in an intercompany transaction as trading stock (refer example 3, appendix). Although the re-classification may seem to be inequitable to a group, it is intended to achieve the same result that would be achieved if the group was a single company that is structured divisionally.

If the acquiring company was entitled to claim capital allowances on the transferred asset, then the deferred intercompany profit or loss would be recognised in group taxable income in the year of disposal.

It is evident that the purpose of this adjustment is to reflect in group taxable income any profit or loss that would be taken into account in taxable income if the first and the acquiring companies were divisions of a single company.

Therefore, an equitable income tax treatment of any deferred intercompany profit or losses is to take into account such amounts in group taxable income in the year of disposal to the asset outside the group. However, such amount should be limited to the difference between actual profit or loss that would be recognised by the acquiring company and the profit or loss that would have been recognised in taxable income if the acquiring and the first companies were divisions of a single company (refer example 3, appendix).

2.3 Income tax avoidance

As the single legal entity treatment may require deferral of intercompany profits and losses (hereinafter 'deferred intercompany profit or loss balances') without specific income tax legislation, a group of companies may avoid income tax on such balances and any subsequent profit or loss on disposal of the asset outside the group by disposing of its equity in the company owning the asset that was transferred in an intercompany transaction (acquiring company), instead of disposing of the asset outside the group *(Henry Beck Builders v Commissioner (1964) 41 TC 616).*

Therefore the problem is to determine an equitable income tax treatment of group profit or loss on an asset that was transferred in an intercompany transaction, upon disposal by a group of the acquiring company so that a single legal entity effect could be achieved on group taxable income.

In US, upon departure of the acquiring company from the group, the deferred intercompany profit and loss balance is included in group taxable income in the tax year of such departure (Reg 1.1502-13(d)(1)(i)). Whether or not that deferred balance is of a revenue nature (referred to in US as ordinary income) is determined according to the treatment of the asset by the first and acquiring companies (Reg 1.1502-13(d)(3)(e.g.2(b)), subject to an overriding requirement that if capital allowances were claimed on the asset by the acquiring company, then the deferred intercompany profit or loss is classified as of a revenue nature (Reg 1.1502-13(d)(3)(e.g. 2(c)).

Application of this principle to South African income tax law, would require that:

- if the asset is held as trading stock by the acquiring company then, the deferred intercompany profit or loss balance should be classified as profit or loss of a revenue nature;

- if the asset is held as a capital asset, on which no capital allowances were claimed, then the deferred intercompany profit or loss should be treated as capital profit or loss and not be taken into account in taxable income; and
- if the asset is held as a capital asset on which capital allowances were claimed by the acquiring company then the balance of the intercompany profit or loss will be treated as an amount of a revenue nature.

Although in nature (capital or revenue) this classification will yield results consistent with the treatment of a group of companies as a single legal entity, in amount, the group profit or loss would differ with the profit or loss of a single company carrying on a similar business through divisions by the profit or loss that the acquiring company would have recognised if the asset was disposed of outside the group immediately prior to departure from the group.

It is considered that a departure of a company from a group is similar to a disposal of a division by a company that carries on trade through divisions. In South African income tax law, where a division is disposed of, a profit or loss on an asset is the difference between the cost and a portion of proceeds on disposal as allocated to that asset *(Commissioner v Niko (1940) 11 SATC 124).*

This treatment would, therefore, require that a group should include in group taxable income, in addition the deferred intercompany profit or loss balance, any profit or loss that would have been taken into account by the acquiring company had the asset been disposed of outside the group so that the total group profit or loss should equal the profit or loss that would have been taken into account if the single company that is structured divisionally had sold a division that held an asset that was transferred in an interdivisional transaction.

However, the problem with the US system is that the treatment of the deferred intercompany profit or loss as wholly of a revenue nature (where the acquiring company claimed capital allowances on the asset) may subject to income tax any deferred intercompany capital profit that would not be subject to tax on a single legal entity basis. This problem arises by reason of the connected persons rule (s1 SA Act) which may limit the amount on which capital allowances could be claimed by the acquiring company to the cost of the asset to the company from which the asset was acquired or the market value on date of transfer (for example, s11(e)(viii) SA Act).

It is submitted that, an income tax treatment that is consistent with the single legal entity treatment would be to include in group taxable income the deferred intercompany profit balance to the extent that such balance was not determined to be a capital profit in the tax year that asset was transferred in an intercompany transaction. This treatment also eliminates any possibility of double counting deferred intercompany profit balance in group taxable income.

Therefore, upon departure of the acquiring company from a group, an equitable group income tax treatment is to include in group taxable income, in the year of such departure:

- any deferred intercompany profit or loss balance of a revenue nature as determined by considering the treatment of the asset by the acquiring company, but excluding any intercompany profit that was determined to be of a capital nature at the time the asset was transferred to the acquiring company; and
- any profit (including recoupment) or loss (including scrapping allowance) that would have been included in group taxable income if the transferred asset was sold outside the group

immediately before departure of the acquiring company (notional profit or loss).

However, the notional profit or loss that should be included in group taxable income in respect of the transferred asset should be limited to the difference between the deferred intercompany profit or loss balance actually included in group taxable income (as discussed above) and any profit or loss that would be recognised in taxable income of a single company structured divisionally upon disposal of an asset transferred in an interdivisional transaction.

Also, the acquiring company should be deemed to have acquired the transferred asset at the cost that it would have incurred to acquire that asset in an arm's length transaction immediately prior to departure from its old group.

3 Disposal and acquisition of subsidiary companies

3.1 Disposal

Where a parent company sells a division, such a transaction is treated as a disposal of the individual assets of that division and the proceeds on disposal are allocated to the assets that are being disposed of *(Commissioner v Niko (1940) 11 SATC*

124). Consequently, upon disposal of that division, any profits or losses of a revenue nature on the assets of that division (including any recoupments and scrapping allowances) are taken into account in taxable income of the parent company in the tax year of such disposal.

On the contrary, whenever a parent company of 'a group' sells any of its subsidiary companies that were previously included as part of that group the separate legal identity of those subsidiaries is not disregarded and no income tax consequences would result in relation to the assets of those subsidiary companies.

Therefore, the problem is to determine an equitable income tax treatment of the disposal of subsidiary companies by a group so that the effect of a single legal entity may be achieved in group taxable income.

In UK, as group income tax legislation only applies to current year tax losses the single legal entity treatment of assets owned by any subsidiary that departs from a group is not dealt with in the group income tax legislation.

Similarly in US, upon disposal of a subsidiary company by a group the separate legal identity is not disregarded (Duboff & Broadbent, 1994: 745) and such disposal does not result in any income tax consequences to the group in relation to the assets of that subsidiary company (except for assets transferred in intercompany transactions, discussed in section 2.3). The only impact on group taxable income relates to the gains or losses on the disposal of the shares of those subsidiary companies (Reg 1.1502-32(a)(3); *Woods Investment Company v Commissioner (1985) 85 USTC 274).*

As gains and losses on disposal of shares are not subject to income tax in South Africa (except for sharedealers), the UK and the US systems do not provide any guidance to resolving the problem that exists in the South African income tax system.

However, as the single legal entity treatment requires that the separate legal identity of all subsidiary companies that are part of the same group should be disregarded (refer chapter 1, section 2.4), it is submitted that the separate legal identity of any subsidiary company that is disposed of should be ignored for income tax purposes, and such disposal should be treated as a disposal of the assets of that subsidiary.

> Furthermore, assets of that subsidiary company should be deemed to be disposed of for proceeds equivalent to the proceeds that would have been received or accrued by the group if that subsidiary company was actually a division of a single legal entity (notional proceeds). Consequently, any profits or losses of a revenue nature (including recoupments and scrapping allowances) that would have been taken into taxable income upon disposal of those assets outside the group should be taken into account in determining group taxable income in the tax year of disposal. Also, the subsidiary should be deemed to have acquired its assets at a cost equivalent to the notional proceeds.

Therefore, an equitable income tax treatment of the disposal of any subsidiary company by a group is to treat such disposal as a disposal of the assets owned by that subsidiary outside the group and any profits or losses of a revenue nature relating to those assets (including any recoupments and scrapping allowances) should be taken into group taxable income in the tax year of disposal. Furthermore, the proceeds on disposal of the assets of that divisions should be deemed to be proceeds that would have been realised had the assets been actually disposed of outside the group immediately prior to disposal of that subsidiary company (notional proceeds).

3.2 Acquisition

When a parent company acquires a division, based on the principle established in *Niko's case (supra),* the acquisition of that division is treated as the acquisition of the individual assets and therefore the cost of the division is allocated to the acquired assets. The cost for income tax purposes is the cost of acquisition to the parent company.

However, where a group of companies acquires a subsidiary company the separate legal identity of that company is not ignored, and consequently the cost of the assets owned by that acquired company to the group for income tax purposes is the cost of the assets to that subsidiary company, and not the cost of the assets to the group on date of acquisition.

Therefore, the problem is to determine the equitable income tax treatment of the assets of any acquired subsidiary company to achieve the single legal entity effect on group taxable income.

In both UK and US, the group income tax law does not deal with the single legal entity treatment of the assets owned by the acquired subsidiary at the time of acquisition.

A single legal entity treatment of the acquired subsidiary would require that the separate legal identity of the acquisition of the shares of any subsidiary company should be treated as the acquisition of assets by the group (Duboff & Broadbent, 1994: 746) and the cost of the assets to the group should be the cost to the group at acquisition.

However, the reason for not disregarding the separate legal identity of an acquired subsidiary company is that the single legal entity treatment is only appropriate for a period when the parent company and its subsidiary companies file a single income tax return (Duboff & Broadbent, 1994: 772). Accordingly, the separate legal identity of an acquired company should only be disregarded after that company becomes a member of a group and not at the time of acquisition.

This treatment may, however, lead to double taxation. For instance, where a subsidiary is acquired from another group, it would require that when the assets of that subsidiary are ultimately sold outside the group, the new group should be taxed on the profits or losses of a revenue nature arising from disposal based on the original cost of those assets to the acquired subsidiary, whereas those profits or losses would have already been subject to income tax (wholly or partially) in the taxable income of the previous group (refer section 3.1).

Furthermore, this treatment would be inconsistent with the income tax treatment of a division acquired by a single parent company within the existing South African income tax law (SA law). In terms of SA law, the tax values of the assets acquired from a division of another company should be, except for income tax avoidance purposes, based on the cost of the assets to that acquiring company.

Therefore, an equitable income tax treatment should be to consider an acquired subsidiary as a division and the assets of that subsidiary should be deemed to be acquired at a cost that would be incurred in an arm's length transaction if the acquired subsidiary was actually a division of a single company.

However, where an acquired subsidiary was not a member of another group, a further issue arises, which is to determine an equitable income tax treatment of any 'notional' profits (including recoupments) or losses (including scrapping allowances) of a revenue nature that results from treating the acquired subsidiary as a division of a single company.

It is submitted that an equitable income tax treatment in those circumstances is to consider the acquired subsidiary as 'a group'. Consequently, it should include in its taxable income (prior to joining the group) any profits or losses of a revenue nature that would have resulted if the assets were sold in an arm's length transaction immediately prior to that company joining the group (section 3.1, above).

4 Expenditure incurred on behalf of the group

If a company in a group (first company) incurs a revenue expenditure in connection with or for the purposes of trade carried on by another company in the same group, such expenditure is not deductible for income taxation purposes in South Africa, to the extent it was not incurred for the purposes of the first company (s23(g) SA Act).

This law was established in *Solaglass Finance Co. (Pty) Ltd v CIR (1991) 53 SATC 1* (a case which led to the amendment of s23(g) to allow apportionment between trade and non-trade expenditure), where a group financing company suffered a loss as a result of irrecoverable loans from one of the members of the group. It was held that such losses were not deductible because the company had incurred the losses as a result of dual motives; being profit making (trade) and promotion of group interest (being non-trade).

Therefore the problem is whether or not it is appropriate to limit 'carrying on of trade' or 'carrying on of business' to the trade or business that is carried on by a company that incurred the expenditure.

In UK, where any company in a group incurs an expenditure in connection or for the purposes of the trade carried on by other companies in the same group such expenditure is not deductible for income tax purposes *(Marshall Richards Machine Co. Ltd v Jewitt (1950) 36 TC 511 at 525)*. In this case, a parent company paid sums of money to a subsidiary in terms of a contract. The court held that the amounts were not deductible because they were incurred for the purposes of the trade of the subsidiary and not trade of the taxpayer. In reaching this conclusion the court said that

> '... where the parent company and the subsidiary enter into trading relationships there is, of course a dual relation, but *you cannot for the purposes of tax disregard the fact that there are, in fact, two entities and two trades*, that is to say the trade of each company. It is normally a question of fact whether the disbursement in question is laid out wholly and exclusively for the purposes of the trade of the parent company, or secondly, whether it is laid out wholly and exclusively for the purposes of the trade of the subsidiary company, or thirdly, whether it is laid out partly for the one and partly for the other. In the first case the parent

> company succeeds in getting an allowance in the other two cases it does not' *(emphasis added).*

Similarly, in US, where a company incurs expenditure for the purposes of business carried on by another member, such expenditure is not deductible for income tax purposes *(Interstate Transit Lines v Commissioner (1942) 42-1 para 9168).* In this case a parent company had made payments to a subsidiary to compensate the subsidiary for losses incurred in carrying on a business, the court held that the parent company could not deduct the payments because for they were not necessary business expenses. In rejecting the taxpayer's contention that the subsidiary is effectively a division of the parent company, the court said that

> 'the corporate entity of the subsidiary cannot be disregarded nor the tax disadvantage resulting from its organisation avoided'.

Clearly, the interpretation of trade or business carried on UK and US undermines the purpose of the single legal entity treatment, which requires that the artificial distinction caused by the separate legal existence of each company should be ignored (refer section 2.4, chapter 1).

Furthermore, the group is considered to be in a similar position to a business that is structured through divisions, which for income tax purposes is regarded as carrying on trade or business as a single taxpayer, irrespective of whether or not divisions carry on trade of a different nature.

For the reason that the UK and US treatment of expenditure incurred for the purposes of or in connection with the trade carried on by other members of the group is inconsistent with the single legal entity treatment, such expenditure should be fully deductible from group taxable income.

5 Chapter summary

In this chapter, group income tax treatment of intercompany transactions, disposal and acquisition of subsidiary companies, and expenditure incurred in connection with and for the purposes of trade or business carried on by other companies within the same group has been established. The essence of this treatment is to disregard the separate legal identity of each company within the same group.

CHAPTER 5

TAX LOSSES

1 Introduction

In this chapter, the income tax problems relating to the deductibility of tax losses (referred to in South Africa as assessed losses) for groups of companies within the South African income tax law are first identified, after which an examination of the UK and US systems is made in order to establish an equitable treatment of such tax losses in a group income tax system for South Africa.

The first part of the chapter deals with tax losses incurred by a company after acquisition by a group (post-acquisition tax losses), and the last part deals with the tax losses that have been incurred prior to acquisition of a company by a group (pre-acquisition tax losses).

2 Post-acquisition tax losses

Owing to the failure of the South African tax law to recognise a group of companies as a single legal entity carrying on business through divisions for income tax purposes (except for companies in the shipping industry refer section 2.6.2, chapter 1):

(i) current year tax losses of a subsidiary company are not deductible from taxable income of the parent company (s20(1)(b) SA Act). Furthermore, if current year tax losses are not completely deducted from taxable income from other trades of the same company in a group, during any tax year, such losses are not deductible from the taxable income of other companies in the same group for the same tax year. Instead, these tax losses are carried forward to the following tax year and deducted from taxable income of the company that incurred them *(ITC 664 16 SATC 125 at 126);*

(ii) the balances of tax losses carried forward to future years are not deductible from the taxable income of other companies in the same group for the year such losses are carried forward to. These balances are only deductible from the taxable income from trade of the company that incurred them (s20(1)(a) SA Act);

(iii) if a company does not carry on trade during any tax year, it loses its right to carry forward the balance of the assessed loss incurred in previous years *(SA Bazaars (Pty) Ltd v CIR (1952) 18 SATC 240)* even if other companies in the same group carried on trade during that period; and

(iv) tax losses incurred by a company in a group remains with that company upon departure from a group. Therefore, these losses are not available to the group for deduction even though they were 'incurred' by that group as a single legal entity.

Therefore, the problem is to determine an equitable treatment of post-acquisition tax losses to achieve a single legal entity effect in group taxable income.

2.1 Tax losses incurred in the current year

In UK, tax losses incurred in the current tax year are deductible from taxable income of other companies in the same group for that year. There are no restrictions on the deduction of such tax losses (s403(1) UK Act), irrespective of differences in the natures of trades carried on by other companies within the group.

Similarly, in US there are no restrictions on deductibility of tax losses incurred against taxable income of the group (Reg 1.1502-21(a)&(b)).

The deductibility of current year tax losses has been supported in both UK and US on the basis that a group is a single legal entity for income tax purposes.

In UK, the deduction of current year tax losses from current year taxable income of other companies in the same group is supported on the basis that such a treatment achieves similar results to those of a company that carries on trading activities through divisions, whereby losses are deductible from profits in determining taxable income *(Pilkington Brothers v IRS (1982) STC 103).*

Similarly in US, it is established law that a deduction of such tax losses from taxable income of other companies in the same group, is an inherent benefit of recognising a group of companies as a single business unit *(Zanesville Investment Company v Commissioner (1964) 64-2 para 9 700 at 93 761).*

It is evident from these decisions that even if the deduction of such tax losses results in a reduction of the group income tax liability, equity is an overriding consideration (US Senate Report, 1918, in: *Gould Coupler's case (supra)).*

Furthermore, by deducting current year tax losses from taxable income of other companies in the same group, a group of companies will be placed in the same income tax position as a single company trading through divisions, which according to South African income tax law, is permitted to deduct losses incurred by one division against profits made by other divisions.

Therefore, it is equitable for current year tax losses incurred by a company in a group to be deducted from taxable income of other companies within the same group.

2.2 Balances of tax losses carried forward

In UK, as only tax losses that have been incurred in carrying on trade during the current tax year (s403(1) UK Act) are permitted to be deducted from taxable income of other companies within the group, any remaining balance not utilised by a group and carried forward to future tax years is only deductible from future taxable income of the company that incurred the tax loss (s393(1) UK Act).

In contrast, in US, tax losses carried forward are deductible from group taxable income in the year they are carried to.

These balances are not restricted to the taxable income of the company that incurred the tax loss (Reg 1.1502-21(a)&(b)).

First, an examination of the purpose of the provisions of the legislation, that relate to the carrying forward of tax losses, is made in order to establish an equitable treatment of these balances for group income taxation purposes. These provisions

> '...were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years and to strike something like an average taxable income computed over a period longer than one year' *(Libson Shops Inc. v Koehler (1957) 57-1 USTC para 9 691 at 57 556).*

Therefore, this purpose requires that if a portion of tax losses has been deducted from taxable income in the year the tax losses were incurred, any balances that have been carried forward to future tax years should be deductible from taxable income in those years.

The application of this principle to groups would require that as tax losses incurred during any year are deductible from taxable income of other companies within the group for the same year (section 2.1), these tax losses should be permitted as a deduction from taxable income of other companies within the same group in the years they are carried forward to.

For the reason that the UK system restricts the deduction of these balances to the taxable income of the company that incurred them, this system is inconsistent with this principle.

In contrast, the US system is consistent with the income tax treatment of tax losses incurred by a company trading through divisions in terms of the current South African income tax law.

Therefore, an equitable income tax treatment of the balances of tax loss carried forward by any company in a group, is to deduct them from the taxable income of other companies within the same group in the year such balances are carried forward to.

2.3 Balances of tax losses carried forward - ceasing trade

In UK, if the company ceases to carry on trade, the right to carry forward the balance of the assessed loss is lost *(J.G. Ingram & Sons Ltd v Callaghan (1968) 45 TC 151 at 170)* whether or not other companies within the group continue to carry on trade.

In contrast, in US, as the tax losses of each company within the group become part of the group tax losses, the deductibility of such tax losses is not affected by the cessation of trade by any members of a group (Reg 1.1502-21(a)&(b)).

The principle with which these treatments are to be evaluated for appropriateness in South Africa, is that, tax losses should be deductible from the taxable income of a business that suffered the burden of the actual economic tax loss (burden of economic tax loss principle) (*Joseph Weidenhoff Incorporated et al v Commissioner (1959) 32 TC 1 222 at 1 237; United States v Northern Railroad (1964) 64-2 USTC para 9674: 93 687 at 93 688).*

In *Joseph Weidenhoff's* (supra), a group sought to deduct a portion of post-acquisition tax loss balances carried forward of a company that had ceased trading, from its taxable income. In allowing the deduction, the court established that the affiliated group owned the business that suffered the tax losses. The tax loss was allowed on the basis that the parent company, through its ownership of shares in the subsidiary, had suffered the actual economic loss.

In *Northern Railroad* (supra), the taxpayer sought to deduct post-acquisition tax loss balances carried forward relating to two of its subsidiaries. The court held that the company and its subsidiaries constituted a single economic legal entity and to disallow the losses of the subsidiaries would create an artificial distinction between a business that is structured through divisions and a business that is structured through subsidiaries.

According to these decisions, the UK system undermines the group income taxation principle of treating a group of companies as a single business unit (refer chapter 1). It is this business that suffered the actual economic tax loss. Furthermore, this system ignores the fact that the group owns a company that incurred the loss, and a group incurred the tax loss during that period of ownership. Therefore, in reality the group as a single business enterprise incurred such a loss.
In contrast, by allowing the deduction of the balances carried forward from taxable income, the US system recognises that a group as a single economic entity suffered the tax losses.

Thus, if a group is viewed as a single economic entity, the cessation of trade by any of the companies in the group should not affect the deductibility of the tax losses incurred. so long as other companies within the group continue to carry on their respective trades.

This treatment is also consistent with the income tax treatment of a company structured through divisions in terms of the current South African income tax law treatment.

Therefore, based on the burden of the actual economic tax loss principle, it is equitable for tax losses of a company that has ceased trading to remain available to the group for income tax purposes so long as the other companies in the same group continue to carry on their respective trades.

2.4 Balances of tax losses carried forward - departing from a group

In UK, as the post-acquisition tax losses are only deductible from taxable income of a company that incurred them (s393(1) UK Act), upon departure of that company from a group, tax loss balances incurred by that company remain with that company.

However, in US, such portion represents a proportion of the group tax loss determined as a ratio of the tax loss incurred by the departing company to the sum of tax losses incurred by other companies within the group in the year the tax loss arose (Reg 1.1.502-79(a)(3)).

In terms of the burden of the economic loss principle (refer section 2.3) established in *Joseph Weidenhoff* (supra) *and Northern Railroad* (supra), the actual loss was suffered by a group, as a single business unit.

Although both cases dealt with the deductibility of the tax losses where the companies involved had ceased trading operations, it is submitted that this principle is equally applicable to companies departing from a group.

Whether a company departs from a group or ceases to carry on a trade, the post-acquisition tax losses were incurred by such a company during a period which that company was a member of a group. In both cases the burden of the economic loss is borne by the group as a single legal entity.

For this reason, it is considered that to allocate post-acquisition tax losses incurred by the group to departing companies is inconsistent with this principle. Furthermore, such allocation is also inconsistent with the income tax treatment of a disposal of a division by a company that carries on trade/business through divisions in terms of the current South African income tax law. According to South African income tax law, losses of a division that is disposed remain with the parent company.

Therefore, it is equitable for tax losses incurred by a company departing from a group to remain available to a group subsequent to such departure.

3 Pre-acquisition tax losses

In South Africa pre-acquisition tax losses of an acquired company are only deductible from post-acquisition taxable income of that company (s20(1) SA Act).

The recognition of a group as a single legal entity raises a problem of deductibility of pre-acquisition tax losses from group taxable income. This problem is unique to groups of companies, and does not arise in the case of a parent company that carries on business through divisions because any losses that are incurred by a division cannot, in terms of South African tax law, be allocated to that division upon its disposal or acquisition.

Therefore, the problem is to determine an equitable treatment of pre-acquisition tax losses to achieve the effect of a single legal entity in group taxable income.

3.1 Tax losses of subsidiary companies

In UK, pre-acquisition tax losses of subsidiaries are deductible from post-acquisition group taxable income. The amount to be deducted each year, is however limited to the post-acquisition taxable income of the acquired company (s393(1) UK Act).

Similarly in US, pre-acquisition tax losses that can be deductible from group taxable income is limited each year to the difference between group taxable income including the taxable income of the acquired company and the group taxable income excluding the taxable income of the acquired company (Reg 1.1502-21(c)(2)). Effectively, the pre-acquisition tax losses that can be deducted each year are limited to the post acquisition taxable income of the acquired company.

The main reason for limiting such tax losses to the taxable income of the of the acquired company is to eliminate tax avoidance schemes that involve, profitable groups acquiring loss making companies that incurred tax losses *(Woolford*

Realty Company v Collector (1931) 3 USTC para 938 at 3 278). In this case, a parent company sought to deduct pre-acquisition tax losses of the subsidiary against its taxable income. It was held that such tax losses could not be deductible because it would mean that

> ' ...a prosperous corporation *(company)* could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated *(group)* return was willing to foster an opportunity for juggling so facile and so obvious. Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another' *(italics in brackets added for clarity).*

However, the subsidiary in that case had incurred a tax loss for the year in question. The court did not determine whether any portion of the pre-acquisition tax loss would have been deductible, had the subsidiary had taxable income during the tax year in issue.

This problem was addressed in *Wolter Construction Company v Commissioner (1977) 68 TC 39 at 46).* In this case, the court said that the history of the group income tax returns indicates that the intention of the legislation was

> '... not to allow *(pre-acquisition tax)* loss carryovers incurred by one corporation prior to a consolidated return year to be deducted in the return for that year beyond the amount of that corporation's *(company)* income in that return, even where the same shareholders controlled both corporations prior to consolidation *(grouping)*' *(italics in brackets added for clarity).*

The purpose of this limitation is also consistent with the burden of economic loss principle (refer section 2.3 above), which requires that the tax losses should only be deductible from the taxable income of a business (the group) that 'actually' suffered these losses.

Consequently, there would not be any justification to deduct such tax losses from taxable income of other companies within the group.

Therefore, an equitable income tax treatment is to restrict the deductibility of pre-acquisition tax losses to the taxable income of the company that incurred the tax loss.

3.2 Tax losses incurred by the parent company

In UK, there is no legislative provision that allows tax losses of parent companies to be deductible from taxable income of its subsidiaries, therefore tax losses of the parent company that are deductible from group taxable income are limited to the taxable income of the parent company (s393(1) UK Act). In US, however, the pre-acquisition tax losses of the parent company, are deductible from taxable income of other companies in the same group, and not limited to the taxable income of the parent company (Reg 1.1502-1(f)(2)(i)).

The deduction of pre-acquisition tax losses of the parent company from taxable income of other companies in the group is justified on the basis that a group of companies is a single business unit for income tax purposes (*S Slater & Sons Inc. v White (1941) 41-1 USTC para: 9 467*). In this case, the parent company of the group had incurred pre-acquisition tax losses prior to incorporation of two of its subsidiaries. Subsequent to incorporating these subsidiaries, in determining the group taxable income the parent company sought to deduct the tax losses from the taxable income of the parent company only. The court held that to be consistent with the single legal entity treatment, the tax losses of the parent company should be deducted from the taxable income of the group as a single legal entity.

If the tax losses incurred by the parent company are limited to its taxable income, a group of companies would be at a disadvantage as compared to a similar business structured through divisions, because in terms of South African income tax law, such a business would be allowed to deduct tax losses against taxable income from any other division (s20(1)(b) SA Act).

By acquiring a subsidiary, it is submitted that the parent company is in a similar position as business that is structured divisionally that expands into other trades. Therefore on the basis of *S Slater & Sons'* decision (supra), it is appropriate that such tax losses be determined on a single legal entity basis.

Therefore, an equitable treatment of tax losses of the parent company is therefore to deduct such tax losses against the taxable income of that parent company and taxable income of its subsidiary companies.

The only issue that would still need to be dealt with is the elimination of tax avoidance schemes whereby groups of companies would avoid the limitation on pre-acquisition tax losses of the acquired subsidiary through reverse acquisitions as follows:

(i) shareholders of the parent company of the group would sell their shares in the parent company to the acquired company that has a pre-acquisition tax loss in return for majority shares in the acquired company;

(ii) the acquired company would become the new parent company; and

(iii) the pre-acquisition tax losses of the new parent company would be fully deductible.

In the US, this issue has been resolved by ignoring the reverse acquisition transaction and treating the old parent company as the parent company of the new group, and the acquired company as the subsidiary of that group (Reg 1.1502-75(d)(3); Reg 1.1502-1(f)(3)).

This treatment is considered to be equitable because it restricts the deduction of the tax losses of the acquired company to the post acquisition taxable income of that company (refer section 3.1 above).

3.3 Tax avoidance

The issue of changing the business of the subsidiary company subsequent to acquisition so that the pre-acquisition tax losses may be utilised is not dealt with in this study as it is considered that the existing income tax avoidance legislation (s103(2) SA Act) is sufficient to deal with such tax avoidance schemes (refer section 5.1, chapter 1 for assumptions made in this study).

According to s103(2), SA Act, the tax losses would not be deductible for income tax purposes if, subsequent to a change in shareholding, income accrues to any company and has the effect of avoiding income tax and the sole or main purpose was to utilise the pre-acquisition tax losses.

4 Chapter summary

In this chapter, the problems relating to deductibility of post-acquisition and pre-acquisition tax losses in a group income tax system existing within the current South African income tax system have been identified and based on the treatment of these problems in the UK and the US an equitable treatment for group income tax system in South Africa has been established.

CHAPTER 6

SUMMARY, CONCLUSION AND AREAS FOR FUTURE RESEARCH

1 Introduction

In this final chapter, the research objective is reconsidered, after which the principles of a group income tax system for South Africa established in the previous chapters are summarised. Finally, areas of future research are suggested.

2 Research objective

As stated earlier, the objective of this thesis is to establish a group income tax system for South Africa so that equity is achieved between shareholders of parent companies that carry on business through subsidiaries and shareholders of parent companies that carry on similar business through divisions.

A group income tax system achieves equity by recognising a group of companies (a group) effectively as a single company that is structured through divisions.

3 Group income tax system for South Africa

First, the definition of 'a group' for income tax purposes is established. Thereafter, an equitable income tax treatment of group transactions and tax losses is established.

3.1 Definition of a group

3.1.1 Qualifying companies

Group income tax should be limited to parent companies and their subsidiary companies that have been incorporated in terms of the laws of the Republic of South Africa (domestic companies) and derive income wholly or partly from a source or deemed source in South Africa.

3.1.2 Ownership

Only companies that are beneficially owned by the group should qualify for a group income tax system.

All classes of shares should be taken into account in determining ownership except if that class of shares:

- does not have rights to vote for directors;
- is not convertible into any other class of shares; and
- has limited rights to participate in profits of that company.

Only subsidiary companies whose shares are not beneficially owned by outside shareholders should qualify for a group income tax system.

In general, options to acquire or sell shares of any subsidiary company should not be taken into account in determining ownership for group income tax purposes. However, where these options are issued in circumstances that constitute income tax avoidance, then such options should be deemed to be exercised for the purposes of determining whether or not a group owns the qualifying classes of shares of that subsidiary company.

3.1.3 Control

A subsidiary company should be included in a group if it is controlled by that group. Control should be considered to exist if the group has power to elect majority of directors to the board of directors of that subsidiary company.

However, the election of the board of directors should not be taken as the sole consideration where there are restrictions on the authority and the power of the board of directors to control the affairs of a subsidiary company. In those cases, all circumstances of each case should be taken into account in determining whether or not the subsidiary company is controlled by that group.

3.2 Group transactions

3.2.1 Intercompany transactions

- **Trading stock**

Intercompany profits or losses that arise from transferring trading stock within the group should, if that asset is held as trading stock by the transferee company, be deferred as long as that trading stock is held within that group.

Intercompany profits or losses that arise from transferring trading stock within the group should, if that asset is held as a capital asset by the transferee company, be recognised in group taxable income for each year only to the extent there is a difference between capital allowances actually claimed by the transferee company on that asset and capital allowances that would be claimed on that asset if the transferor and transferee companies were divisions of a single company. Any profits or losses not recognised should be deferred and carried forward to the following tax year.

Any balances of deferred intercompany profits or losses, as discussed above, should be recognised in group taxable income in the year the transferred asset, whether held by the transferee company as trading stock or a capital asset, is sold outside the group. However, these balances should be recognised in group taxable income only to the extent there is a difference between profit or loss actually recognised by the transferee company on disposal of that asset and profit or loss that would be recognised in taxable income if the transferee and transferor companies were divisions of a single company.

- **Capital assets**

Intercompany profits (including recoupments) or losses (including scrapping allowances) that arise from transferring capital assets within the group should, if the transferred asset is held as trading stock by the transferee company, be deferred and not recognised in group taxable income as long as the asset is held within that group.

Intercompany profits (including recoupments) or losses (including scrapping allowances) should, if the asset is held as a capital asset by the transferee company, be recognised in group taxable income for each year only to the extent there is difference between capital allowances actually claimed by the transferee company and capital allowances that would be claimed if the transferee and transferor companies were divisions of a single company. Any profit or loss that is not recognised should be deferred and carried forward to the following tax year.

Any balances of deferred intercompany profits or losses, as discussed above, should be recognised in group taxable income in the year the transferred asset (whether held by the transferee company as trading stock or a capital asset) is sold outside the group. However, these balances should be recognised in group taxable income only to the extent there is a difference between profit or loss actually recognised by the transferee company on disposal of that asset and any profit or loss that would be recognised in taxable income if the transferee and transferor companies were divisions of a single company.

- **Tax avoidance**

Where the transferee company prior to disposal outside the group of the transferred asset, departs from a group, any deferred intercompany profit or loss of a revenue nature should be taken into account in determining group taxable income in the year of departure.

Whether or not any balance of intercompany profit or loss is of a revenue nature should be determined by reference to the activities of the of the transferee company immediately prior to disposal. The deferred intercompany profit or loss should be reclassified as of a revenue nature and recognised in group taxable income if immediately prior to departure from the group:

- the transferee company held the transferred asset as trading stock; or
- the transferee company held the transferred asset as a capital asset and capital allowances were claimed for income tax purposes on that asset. However, to the extent that the intercompany profit is of a capital nature, as determined on the date of transfer of that asset, such intercompany profit should be treated as capital profit and excluded from group taxable income.

Furthermore, any profit or loss of a revenue nature (including recoupments and scrapping allowances) that would be realised by the transferee company if that asset was sold outside the group immediately prior to departure of that company from the group should be included in group taxable income in the tax year of departure. Also, the transferee company (as discussed above) should be deemed to have acquired the transferred asset at the cost that it would have incurred to acquire that asset in an arm's length transaction.

3.2.2 Disposal and acquisition of subsidiary companies

Upon departure of a subsidiary company from the group, such departure should be treated as a disposal of the assets of that subsidiary for proceeds equivalent to proceeds that would have been realised had the assets of that subsidiary been sold outside the group immediately before such departure. Consequently, any profits or losses of a revenue nature (including recoupments and scrapping allowances) that would have been recognised had the assets been disposed of immediately prior to departure of that subsidiary company from that group should be included in group taxable income in the year of departure of that subsidiary company.

The separate legal identity of any acquired subsidiary company should be disregarded on date of acquisition. Consequently, the cost of the assets owned by that subsidiary company for group income tax purposes should be the cost that would have been incurred in an arm's length acquisition of those assets. Furthermore, where the subsidiary company was not acquired form another group, it should include in its taxable income prior to joining the group, any profits or losses that would have resulted if the assets were sold in an arm's length transaction immediately prior to joining the group.

3.2.3 Expenditure incurred on behalf of the group

For the purposes of determining whether or not revenue expenditure incurred in the production of income by any company within the group was incurred for the purposes of trade, the definition of trade should include trade carried on by other companies within the same group. Consequently, such expenditure should be fully deductible in the tax year it is incurred.

3.3 Tax losses

3.3.1 Post-acquisition tax losses

Current year tax losses incurred by one company should be deductible from taxable income of other companies within the same group.

Any balance of tax losses that are carried forward to future tax years should remain available for deduction against group taxable income and not restricted to the taxable income of the company that incurred them.

Tax losses of a company that ceases to carry on trade should remain available for deduction from group taxable income so long as other companies within the same group as the company that ceased to carry on trade continue to carry on their respective trades.

If a company departs from a group, any balances of tax losses that are carried forward to future tax years should remain available for deduction from group taxable income and not from taxable income of the company that incurred them.

3.3.2 Pre-acquisition tax losses

The deduction of pre-acquisition tax losses of a subsidiary should be limited to the taxable income of that company and not to group taxable income.

The deduction of pre-acquisition tax losses of the parent company should not only be deductible from its taxable income, but also from taxable income of its subsidiary companies that are included in the same group.

However, where a group acquires a company that has a pre-acquisition tax loss through a reverse acquisition in order to avoid the limitation on the tax losses of the subsidiary company then the limitation on tax losses should apply to the pre-acquisition tax losses of that acquired company.

4 Conclusion

The study has established a group income tax system for South Africa so that shareholders of the parent companies that carry on business through subsidiaries should bear the same tax burden as the shareholders of a parent company that carries on a similar business through divisions. Therefore, the inequity that is inherent in the existing South African income tax system should be eliminated.

5 Areas for future research

(i) The study focused only on the equity characteristic of a good tax system. The implications of other characteristics; efficiency, neutrality, and simplicity on a group income tax system should still be researched prior to implementation of this system in South Africa.

(ii) The equity principle should be researched with respect to a group VAT, secondary tax on companies (STC), transfer duty, and stamp duty systems in South Africa.

(iii) Prior to introducing capital gains tax in South Africa, the income tax implications of that system on a group income tax system, as established in this study, should be researched.

(iv) Transitional rules will need to be considered in respect of the introduction of a group income tax system to avert avoidance and the erosion of the existing tax base.

(v) Also, all the sections in the SA Act that presently go some way to achieve a group income tax effect may have to be amended, for example s22A, s24A, and proviso to s24E (leave pay).

APPENDIX

INTERCOMPANY TRANSACTIONS

These examples have been based on the US group income tax law principles as discussed in chapter 4 but adapted for South African income tax law purposes.

Example 1 - trading stock held as a capital asset

Assuming that the acquiring company (as defined in chapter 4) purchases an asset for R100 000 from the first company (as defined in chapter 4) (cost to the first company of the asset is R80 000), and the asset is written off for tax purposes over 5 years. Assuming further that the first company held the asset as trading stock.

Income tax consequences would be as follows:

	first company	**acquiring company**	**single legal entity**
Cost	(80 000)	(100 000)	(80 000)
Proceeds	100 000		
Revenue profit	20 000		
Annual tax allowance on the asset (5 years)	(4 000)	20 000	16 000

Instead of a group recognising intercompany profit of R20 000 in the year of the transaction, the group only recognises profit (or loss) to the extent that the single legal entity is to be achieved. The profit or loss that is recognised in ***each*** tax year (R4 000) is the difference between the capital allowance on the asset (R20 000) and the capital allowance that would have been recognised by the group, had the acquiring and selling companies been divisions of the same legal entity (R16 000).

At the end of the income tax write off period, the total intercompany profit (or loss) would be completely offset by the capital allowance that is claimed by the group on the asset.

It is also evident that transfer pricing is not an issue because the capital allowances and intercompany profit or loss on the asset offset each other to achieve a single legal entity treatment on group taxable income.

It should be noted that the connected persons rule does not apply in this example because the first company held the asset as trading stock and it was not entitled to claim capital allowances on that asset for income tax purposes (s12C(4)(c) SA Act; also s11(e)(viii) SA Act)

Example 2 - disposal of a capital asset by the acquiring company

In year 1, the first company (as defined in chapter 4) sells trading stock (cost, R100 000) to the acquiring company (as defined above) for R120 000. The asset is written off over 5 years for income tax purposes. At the beginning of year 2, the asset is sold outside the group for R98 000.

The income tax effects are determined as follows:

	first company	acquiring company	single legal entity
Cost	100 000	120 000	100 000
Proceeds	120 000		
Revenue profit	20 000		
Tax allowance (year 1)	4 000	(24 000)	(20 000)
Tax value in year 2		96 000	80 000
Proceeds		98 000	98 000
Recoupment	16 000	2 000	18 000

In year 1 the revenue profit of R20 000 would not be taken into account because the asset would not have been disposed of outside the group. In year 2, R 4 000 of the intercompany profit will be recognised in group taxable income to reflect the effect of a single legal entity (R24 000-R4 000). In year 3, the acquiring company, recognises in group taxable income a recoupment of R2 000. The single legal entity effect will be achieved in that year by recognising the intercompany revenue profit of R16 000 (R20 000 - R4 000) in group taxable income. The total group profit for that year would therefore be R18 000 in year 2.

It is therefore evident that the purpose of these adjustments is to ensure that the income tax effects to a group of companies and a company carrying on business of the similar nature through divisions are the same in the year the transferred asset is sold outside the group.

Example 3 - disposal of a capital asset by the acquiring company

The first company sells a capital asset (cost and tax value, R100 000) to the acquiring company for R120 000 in year 1. The acquiring company sells the asset outside the group as trading stock in year 3 for R150 000.

The income tax effects are determined as follows:

	first company	**acquiring company**	**single legal entity**
Cost	100 000	120 000	100 000
Proceeds	120 000		
Capital profit	20 000		
Revenue profit		30 000	50 000

In year 1 the capital profit of R20 000 would not be taken into account because the asset would not have been sold outside the group. In year 3, the acquiring company will ***initially*** include in group taxable income R30 000 for the disposal of trading stock. However, the single legal entity effect will be achieved by reclassifying the intercompany capital profit of R20 000, to be revenue profit, and will be included in group taxable income in the year of disposal.

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